BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DAVID AND AVIS STATE)

For Appellants: Allan V. Africk
Certified Public Accountant

For Respondent: Paul J. Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of David and Avis State for refund of personal income tax in the amount of $5,913 for the year 1979.

The sole issue presented in this appeal is whether appellants are entitled to a bad debt deduction for losses resulting from their guarantee of loans made to their wholly owned corporation.

Appellant, David State, is a physician and his wife, Avis State, is an interior decorator. For a number of years Mrs. State operated an interior decorating service as a sole proprietorship, In 1976, her business was incorporated as Avis State, Inc. Mrs. State elected, for federal purposes, that her corporation have small business corporation status. Appellants were issued stock with a par value of $1,000.

The corporation experienced financial difficulties and obtained a number of loans from appellants in order to continue in business, None of these advances were evidenced by notes or other debt instruments at the time the advances were made. In addition, the corporation borrowed funds from the Grossman Corporation. Before making the loan, however, Grossman Corporation required appellants to act as guarantors for the loan.

In April of 1979, Avis 'State, Inc., owed appellants $157,725. A promissory note, bearing interest at ten percent per year,, was given to appellants. At this time the amount owed by the corporation to the Grossman Corporation had increased to $99,041.

Due to financial difficulties, Avis State, Inc., was liquidated in July of 1979. The liquidating distribution was valued at $206,528. Appellants' stock in the corporation was valued at $1,000, The worthless stock valued at $1,000 and the liabilities in 'the amount of $182,609 were subtracted from the liquidation amount and the net amount of $23,919 was distributed. The debt for $99,041 owed to Grossman Corporation was 'not included in the liquidation amount. Instead, appellants, subsequent to the liquidation, paid the $99,041 directly to Grossman Corporation.

On August 31, 1979, the corporation gave appellants -a promissory note of face value of $75,122 ($99,041 - $23,919). The note was due in five years and paid 'interest at the rate of ten percent per annum. On their amended return for 1979, appellants claimed a business bad debt deduction of $75,122. Respondent treated the loss as a nonbusiness bad debt and denied appellants' claim 'for refund.

Appellants contend that the deduction resulted from the fact that appellants were required to make good on a loan guaranty, which resulted from the corporation's default on its loan from a third party corporate lender. They contend that the corporation's only assets were not liquid assets and that the amount claimed as a deduction was the net amount after appellants had purchased the remaining assets at full value from the corporation, which amount reduced the corporation's indebtedness. Appellants contend that it was the payment of this net sum of $75,122 to the Grossman Corporation that gave rise to the business deduction and not the fact that the corporation owed appellants money when it went out of business. Finally, appellants contend that their motivation was to generate profit as Avis State was the sole owner of the corporation and was employed full time by the corporation.

Business bad debt losses are fully deductible in the year sustained whereas nonbusiness bad debt losses are regarded as short-term capital losses. (Rev. & Tax. Code, § 17207, subd. (d)(l)(B).) The term "nonbusiness debt" is defined in Revenue and Taxation Code section 17207, subdivision (d)(2)(A) and (B) as a debt other than:

> (A) A debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
>
> (B) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The provisions of Revenue and Taxation Code section 17207 are substantially the same as section 166 of the Internal Revenue Code. It is well settled in California that when state statutes are patterned after federal legislation on the same subject, the interpretation and effect given the federal provisions by the federal courts and administrative bodies are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d 653, 658 [80 Cal.Rptr. 4033 (1969).)

Initially, we note that there is no distinction between a loss that results from a direct loan to a corporation and one that results from the guarantee of a loan. (Putnam v. Commissioner, 352 U.S. 82, 92 [1 L.Ed.2d 1441 (1956).) If an employee of a corporation

lends the corporation money primarily to protect his job, he is entitled to deduct the amounts paid as a business bad debt if the loan becomes worthless. (Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).) However, when the guarantor of the corporate debt is both a shareholder and an employee of the corporation, it is difficult to determine whether he executes his guarantee to protect his investment or to protect his job. Mixed motives are not uncommon and the critical question is which of the taxpayer's motives is dominant. (B. B. Rider Corp. v. Commissioner, 725 F.2d 945 (3rd Cir. 1984); Jack G. Goss, ¶ 77,338 P-H Memo. T.C. (1977).) It must be clear from the record that the dominant reason for making the loan was business related rather than investment related. An equally balanced relationship between the two interests, much less a mere significant business-related motivation, is not enough. (Roy . Knoedler, ¶ 74,085 P-H Memo. T.C. (1974).) The issue of which motive is dominant is factual and appellant bears the burden of proving a dominant business motive. (David N. Griffith, ¶ 74,159 P-H Memo. T.C. (1974).)

The Court in United States v. Generes, 405 U.S. 93 [31 L.Ed.2d 62] (1972), based its decision on a comparison of the amount that the shareholder/employee originally invested in the corporation and the amount, after taxes, that he received annually as a salaried employee of the corporation. In the case of Putoma Corp., 66 T.C. 652 (1976), the petitioner was a 25-percent shareholder in the corporation as well as an employee. Although his initial investment was small, the petitioner had consistently lent money to the corporation. The court held that the bad debts the petitioner incurred as a result of these loans were not business bad debts as the motive for making the loans was not to protect his salary, Petitioner received no salary from the corporation but had argued that the expectation of future salaries was his dominant motive for making the loans. As in Putoma, appellant has not received any salary at all from the corporation, In our view, this reduces the likelihood that Mrs. State's employee status was the dominant motivation behind the guaranteeing of the loan to her corporation., Rather, it appears that the loan was guaranteed to protect not only the original $1,000 investment but to protect the loans totalling $157,725 which were made subsequent to the original investment. This is an investment-related motive and not a business-related motive. (See Bernard J. Liebmann, ¶ 79,399 P-H Memo. T.C. (1979).)

Our finding that appellants' motive for guaranteeing the loan was an investment motive is further supported by the case of Wilfred J. Funk, 35 T.C. 42 (1960). In this case, the court found that when advances are made to a corporation with a rapidly declining financial condition, the advances could not have been made with a reasonable expectation of repayment. The advances, therefore, were intended as risk capital which is indicative of the actions of an investor hoping to protect his investment.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of David and Avis State for refund of personal income tax in the amount of $5,913 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 8th day of January , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Richard Nevins , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9